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No. 04-172

IN THE

# Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION, CHASE MANHATTAN BANK, USA, NATIONAL ASSOCIATION, as Indenture Trustees, and DR. BEN S. BRANCH, Chapter 7 Bankruptcy Trustee,

*Petitioners*,

*v.*

HSBC BANK USA and JPMORGAN CHASE BANK, as Indenture Trustees,

*Respondents*.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## REPLY BRIEF

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## STATEMENT PURSUANT TO RULE 29.6

The corporate disclosure statement for Petitioners was set forth at page *iii* of their Petition for a Writ of Certiorari, and there are no amendments to that statement.

## TABLE OF CONTENTS

*Page*

Statement Pursuant to Rule 29.6 ..... i

Table of Contents ..... ii

Table of Cited Authorities ..... iii

Reply to Brief in Opposition

1. The First Circuit Departed from 30 Years of Judicial Practice. ..... 1

2. The First Circuit Ignored This Court's Rule of Preservation of Prior Judicial Practice Absent Contrary Congressional Intent. ..... 3

3. The First Circuit's Limitation of "Applicable Nonbankruptcy Law" to "Generally Applicable State Rules of Contract Interpretation" Is Wrong. ..... 4

4. The First Circuit Usurped the Authority of the New York Court of Appeals to Define Its State's Law. ..... 6

5. The Questions Presented Are Important. ... 7

6. The Questions Presented Are Ripe for Review Now. ..... 9

Conclusion ..... 10

## TABLE OF CITED AUTHORITIES

*Page*

**Cases:**

*Chemical Bank v. First Trust of New York, Nat'l Ass'n (In the Matter of Southeast Banking Corp.)*, 688 N.Y.S.2d 484, 710 N.E.2d 1083 (N.Y. 1999) ..... 1, 2, 3, 9

*Chemical Bank v. First Trust of New York, Nat'l Ass'n (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998) ..... 2, 3

*Forsyth v. City of Hammond*, 166 U.S. 506 (1897) ..... 10

*Patterson v. Shumate*, 504 U.S. 753 (1992) .....3, 4, 5

*United States v. General Motors Corp.*, 323 U.S. 373 (1945) ..... 10

**Statutes:**

11 U.S.C. § 101 ..... 5

11 U.S.C. § 108 ..... 5

11 U.S.C. § 363 ..... 5

11 U.S.C. § 365 ..... 5

11 U.S.C. § 502 ..... 4

11 U.S.C. § 510 ..... 2

*Cited Authorities*


| | *Page* |
|---|---|
| 11 U.S.C. § 522 | 5 |
| 11 U.S.C. § 524 | 5 |
| 11 U.S.C. § 541 | 5 |
| 11 U.S.C. § 552 | 5 |
| 11 U.S.C. § 723 | 5 |
| 11 U.S.C. § 726 | 4 |
| 11 U.S.C. § 927 | 5 |
| 11 U.S.C. § 943 | 5 |
| 11 U.S.C. § 1123 | 5 |
| 11 U.S.C. § 1125 | 5 |
| 11 U.S.C. § 1126 | 5 |
| 11 U.S.C. § 1142 | 5 |
| 11 U.S.C. § 1222 | 5 |
| 11 U.S.C. § 1322 | 5 |

*Cited Authorities*

*Page*

**Other Authorities:**

H. Strickon et al., *Theory Shifts on Rule of Explicitness*, 231 N.Y. L.J. 9 (Aug. 9, 2004) .... 7, 8

*1st Cir. Says Post-Petition Interest May Not Be Paid Under N.Y. Law*, 10 No. 1 Andrews' Bank & Lender Liab. Litig. Rep. 9 (June 7, 2004) ..... 7

D. Schechter, *'Rule of Explicitness' Governing Subordination Agreements Is Invalid As 'Bankruptcy-Only' State-Created Rule*, 2004 Com. Fin. Newsl. 32 (May 3, 2004) ..... 6, 7

*Rule of Explicitness Was Inapplicable in Bankruptcy*, 04-28-04 West's Bankr. Newsl. 7 (Apr. 28, 2004) ..... 7

Respondents' attempt to characterize the important issues before this Court as "largely academic," (Br. in Opp. at 18), stands in stark contrast to the frank description offered by the highest court of the state in which the financial capital of the nation is located:

> [W]e are acutely cognizant of the practical effect that our answer to the certified question will have on a vast sea of subordination agreements not before us now in live cases or controversies, nor even within the framework of this . . . litigation, involving enormous sums of oustanding public debt. . . . This practical policy consequence is a matter of legitimate concern . . . especially with respect to commercial matters where reliance, definiteness and predictability are such important goals of the law itself, designed so that parties may intelligently negotiate and order their rights and duties.

*Chemical Bank v. First Trust of New York, Nat'l Ass'n (In the Matter of Southeast Banking Corp.)*, 710 N.E.2d 1083, 1086 (N.Y. 1999).

The practical and legal effects of the First Circuit's decision are profound, far-reaching, immediate, and—should this Court deny review—irremediable. For all of these reasons, this Court should grant review, and should do so now.

**1. The First Circuit Departed from 30 Years of Judicial Practice.** Respondents seek to minimize the significance of the First Circuit's decision by suggesting that the question of the continued efficacy of the Rule of Explicitness "has arisen in only one other court of appeals decision in the quarter century since the Code's enactment." Br. in Opp. at 3. Rhetoric aside, what Respondents characterize as a "dearth of precedent" (*id.* at 14) in fact reflects the uncontroverted and uniform application of the Rule. Respondents' statement that "the question simply does not come up very often," Br. in Opp. at 14, is true precisely because neither parties nor courts have challenged the vitality of the Rule. Respondents' observations

thus merely underscore the Rule's well-established status as a universally-applied interpretative canon. They also underscore the First Circuit's dramatic departure from well-settled law by declaring that the Rule is dead. No court, until the First Circuit, has ever refused to apply the Rule—in one form or another.[1]

The historical fact is that, contrary to Respondents' contention, the Rule of Explicitness was not displaced as a canon of federal common law until the Eleventh Circuit issued its *Southeast Banking Corp.* decision in 1998.[2] As noted in the Petition (Pet. at 14), the practical effect of that decision was mitigated by the Eleventh Circuit's application of New York's version of the Rule. Accordingly, until the First Circuit issued its decision in April 2004, the Rule of Explicitness had consistently been applied—in one form or another—for thirty years.

But this Court need not take Petitioners' (or Respondents') word for it. As of 1999, two decades after the enactment of § 510(a) in 1978, the Rule of Explicitness was so well-established that the New York Court of Appeals (in response to certification from the Eleventh Circuit) made the following observation:

> Parties to subordination agreements undoubtedly relied on the Rule—their lawyers would have been quite remiss had they not—since recent case law, as

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1. Indeed, until their about-face in the Brief in Opposition, Respondents themselves never challenged the existence or application of the Rule of Explicitness. *See, e.g.*, Senior Indenture Trustees' Reply Brief in Support of Their Appeal from Order Authorizing Fourth Interim Distribution at 2, *In re Bank of New England Corp.*, 295 B.R. 419 (D.Mass. 2003) (No. 01-12229) ("There is no dispute among the parties that . . . New York law has adopted its version of the Rule of Explicitness—which requires specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's post-petition interest demand . . . .").

2. *Chemical Bank v. First Trust of New York, Nat'l Ass'n (In re Southeast Banking Corp.)*, 156 F.3d 1114, 1122 (11th Cir. 1998).

> well as a leading authority and many commentators have consistently recognized the continued vitality of the Rule.

*In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1086 (citations omitted); *see also In re Southeast Banking Corp.*, 156 F.3d at 1124 (inquiring "whether the New York courts would disturb the heretofore uniform treatment of this question, particularly given the evidence that the capital markets appear to have adjusted to the Rule of Explicitness"). Accordingly, there is no gainsaying that the First Circuit's refusal to apply the Rule (in either its federal or state law form) reflects an abrupt departure from three decades of nationally uniform jurisprudence.

**2. The First Circuit Ignored This Court's Rule of Preservation of Prior Judicial Practice Absent Contrary Congressional Intent.** There is also no gainsaying the fact that the First Circuit did not heed this Court's well-established interpretive rule that pre-Code judicial practice is to be regarded as preserved, absent specific contrary Congressional intent. Respondents concede this Court's practice applies at least when ambiguous provisions of the Code are at issue (Br. in Opp. at 10), but then simply assume away any ambiguity in the phrase "applicable nonbankruptcy law" by dismissing the language as "not subtle or challenging." *Id.* at 15. Once again, Respondents succeed only in hoisting themselves on their own rhetorical petard. Although they acknowledge (Br. in Opp. at 9) that this Court has construed the phrase as used throughout the Code "to include federal as well as state law," *Patterson v. Shumate*, 504 U.S. 753, 758 (1992), they then deny that this particular use of it encompasses federal common law rules of construction and further assert that it extends only to certain state laws – apparently those which might be deemed by the First Circuit to be of sufficiently "general" application. They are wrong in those assertions, as discussed below, but their very need to make them underscores their need to have the phrase be ambiguous: capable of one meaning in the context of *Patterson v. Shumate* and

another here. And that fact itself underscores the importance of examining pre-Code practice in this case, and of following this Court's interpretative principles regarding the same, which the First Circuit failed to do.

**3. The First Circuit's Limitation of "Applicable Nonbankruptcy Law" to "Generally Applicable State Rules of Contract Interpretation" Is Wrong.** The First Circuit's limitation of "applicable nonbankruptcy law" to "state law (and, particularly, state contract law)," Pet. App. at 11a, contravenes this Court's refusal so to circumscribe Congress' intent in using the phrase. *Patterson*, 504 U.S. at 758 ("The Code reveals, significantly, that Congress, when it desired to do so, knew how to restrict the scope of applicable law to 'state law' and did so with some frequency.").[3]

To begin with, the First Circuit (and the Eleventh Circuit before it) misapprehended the congressional purpose (and thus the federal interest) involved. Congress explicitly codified previously accepted bankruptcy principles regarding both the suspension of post-petition interest to, and the equitable, *pro rata* allocation of bankruptcy assets among, unsecured creditors. *See, e.g.*, 11 U.S.C. §§ 502(b)(2), 726(b). At the same time, Congress recognized (a) the ability of such creditors to reallocate among themselves—by contractual agreements outside of bankruptcy—the recoveries to which they would otherwise be

3. In his concurrence in *Patterson* (which Respondents cite, Br. in Opp. at 15), Justice Scalia observed:

> When the phrase 'applicable nonbankruptcy law' is considered in isolation, the phenomenon that three Courts of Appeals could have thought it a synonym for 'state law' is mystifying. When the phrase is considered together with the rest of the Bankruptcy Code (in which Congress chose to refer to state law as, logically enough, 'state law'), the phenomenon calls into question whether our legal culture has so far departed from attention to text, or is so lacking in agreed-upon methodology for creating and interpreting text, that it any longer makes sense to talk of 'a government of laws, not of men.'

504 U.S. at 766 (Scalia, J., concurring).

entitled from a debtor in bankruptcy, and (b) that pre-Code federal judicial practice permitted such agreements but had developed rules governing the circumstances under which they would be enforced despite the usual rules (of no post-petition interest and strict pro-rata distribution). Rather than simply outlawing such agreements, Congress determined to continue to permit them, but it also both explicitly empowered bankruptcy courts to enforce them and instructed them to do so "in accordance with applicable nonbankruptcy law." Far from turning their enforcement into a free-for-all dependent on the laws of the 50 states, it is clear that Congress envisioned the uniform enforcement of such agreements according to the rules which had previously been developed, and there is nothing in the language of the Code or its history to suggest otherwise.

Even if this federal interest were disregarded, the First Circuit's distortion of "applicable nonbankruptcy law" as meaning only "generally applicable state rules of contract interpretation," Pet. App. at 12a, would still be clearly wrong. By use of the phrase "applicable nonbankruptcy law" (which appears in at least 17 different sections, and numerous subsections, of the Bankruptcy Code),[4] Congress must necessarily have intended to encompass "any relevant nonbankruptcy law." *Patterson*, 504 U.S. at 759. Stated differently, when Congress explicitly empowered *bankruptcy* courts to apply *nonbankruptcy* law, it knew they would be doing so in a bankruptcy "context" but not as part of the underlying bankruptcy itself; i.e., they would be dealing with circumstances occasioned by the bankruptcy filing, but not legally part of it.[5]

4. *See* Sections 101(35A)(F); 108(a), (b), (c); 363(f)(1); 365(c)(3), (h)(1)(A)(i), (h)(1)(A)(ii), (h)(1)(C), (h)(2)(A)(i), (h)(2)(A)(ii), (n)(1)(A), (n)(1)(B), (n)(1)(B)(ii), (n)(2)(C)(i), (n)(4)(A)(ii); 522(b)(2)(B); 524(c); 541(c)(1), (c)(2); 552(b)(1); 723(a); 927; 943(b)(6); 1123(a), (d); 1125(d); 1126(b)(1); 1142(a); 1222(d); and 1322(c), (c)(1), (e).

5. The First Circuit failed to appreciate the distinction between rules which (like New York's version of the Rule of Explicitness) are triggered **by** the filing of a bankruptcy case, and rules that apply only **in** bankruptcy.

Contrary to Respondents' contention, therefore, the language must broadly encompass—as this Court itself has determined—all "relevant" laws which exist independently from, and outside of, the Bankruptcy Code, whether they be of general or specific application, and whether or not their application is triggered by the fact that a bankruptcy has occurred.

Indeed, if left undisturbed, the First Circuit's decision will have a wide-reaching impact on 'bankruptcy-specific' state laws which hitherto have rightly been considered "applicable nonbankruptcy law." *See* D. Schechter, *'Rule of Explicitness' Governing Subordination Agreements Is Invalid As 'Bankruptcy-Only' State-Created Rule*, 2004 Com. Fin. Newsl. 32 (May 3, 2004) (recognizing "far-reaching effect [of First Circuit's decision] on many state statutes and rules of decision that purport to take effect upon the bankruptcy of a party," noting, in particular and by way of example, the invalidation of the Uniform Partnership Act's "bankruptcy-only" dissolution rule under the First Circuit's analysis, and warning of "many other examples of this same phenomenon").

**4. The First Circuit Usurped the Authority of the New York Court of Appeals to Define Its State's Law.** Respondents' only attempted justification of the First Circuit's refusal to acknowledge the Rule of Explicitness as part of New York state contract law, despite the express declaration by the New York Court of Appeals that the Rule *is* part of its state's law, is to repeat what the First Circuit itself said: that it would be happy to apply any state law requirement of explicitness that is a "nonbankruptcy law." *Cf.* Br. in Opp. at 16. But that promise is empty in this context. Any law which references "post-petition interest" is impermissible in the eyes of the First Circuit, because that is a "bankruptcy" term. The Rule of Explicitness, however, requires the express use of that very term, thus providing certainty to all involved. So, what the First Circuit—and now Respondents—are saying is that New York cannot have a Rule

of Explicitness that is in fact "explicit": it can only have one that is more vague, and thus less certain of application. This is defended by Respondents as merely being the First Circuit's interpretation of a federal statute, *cf.* Br. in Opp. at 16, but there is no indication that Congress intended to change the requirements of the Rule in order to favor uncertainty, or to prevent States from using certain words in their own laws.

**5. The Questions Presented Are Important.** This Court has never based the exercise of its certiorari jurisdiction on the number of cites to media coverage. Nonetheless, Respondents raise as a reason for denying the writ their inability to find mention of the ruling "in any significant business publication." Br. in Opp. at 18. Contrary to Respondents' statement, the First Circuit's decision, despite its recency,[6] has indeed been noted by the commentators, who have acknowledged both the unprecedented nature of the decision as well as its profound impact. *See, e.g.*, H. Strickon et al., *Theory Shifts on Rule of Explicitness*, 231 N.Y. L.J. 9 (Aug. 9, 2004) ("In holding New York's bankruptcy specific 'Rule of Explicitness' unenforceable, the First Circuit in Bank of New England Corp. reached a conclusion that is at odds with both the result and tenor of Southeast Banking Corp."); *1st Cir. Says Post-Petition Interest May Not Be Paid Under N.Y. Law*, 10 No. 1 Andrews' Bank & Lender Liab. Litig. Rep. 9 (June 7, 2004) (recognizing that First Circuit's decision "creat[ed] a split among the federal appellate courts" on "an issue of first impression"); Schechter, *supra*, at 32 (recognizing "far-reaching effect [of First Circuit's decision] on many state statutes and rules of decision that purport to take effect upon the bankruptcy of a party"); *Rule of Explicitness Was Inapplicable in Bankruptcy*, 04-28-04 West's Bankr. Newsl. 7 (Apr. 28, 2004) (acknowledging First Circuit's decision as "[a]ddressing an issue of apparent first impression in the circuit. . . .").

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6. The First Circuit issued its opinion on April 13, 2004, and denied a petition for rehearing *en banc* on May 5, 2004.

Actually, the silence which is most telling is Respondents' own. Respondents cannot—and thus do not—contest that the First Circuit has fostered an irreconcilable circuit and state court conflict, and that hundreds of billions of dollars of subordinated debt issues are affected as a result. Nor have Respondents addressed the discordant results which will ensue when courts within the First Circuit are prohibited from applying the Rule, while courts within the Eleventh Circuit are required to apply it.[7] Respondents have also not confronted the commercial uncertainties created by the First Circuit's decision. Respondents' only proposed solution—that market participants "add[] a single unambiguous phrase to their subordination agreements—'including post-petition interest' or 'excluding post-petition interest,' depending on their intent" (Br. in Opp.

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7. Respondents also ignore the surge of litigation which will now arise as a result. The First Circuit's decision stands as an invitation to senior subordinated creditors to challenge less-than-explicit language which previously would simply have failed the Rule:

> For a litigator, Bank of New England Corp. may represent a shift in the landscape of [a] case[ ] regarding the availability through a subordination agreement of postpetition interest which would otherwise be unavailable under the Bankruptcy Code. It now appears that the absence of 'explicit' language providing for such interest will not necessarily be fatal to a senior creditor's claim. Instead, such language will likely be viewed as 'ambiguous' and the crux of contested cases will shift from whether language is 'explicit' to a more fact-intensive inquiry regarding the parties' intent.

*See Strickon*, *supra*, at 9. So, too, will the First Circuit's decision encourage parties seeking application of the Rule to commence actions in the state courts of New York, thus defeating the congressional purpose served by empowering bankruptcy courts to enforce subordination agreements in the first place—the uniform resolution of bankruptcy and non-bankruptcy issues in one forum.

at 18)—even if tenable,[8] would provide no certainty to the vast multitude of parties to existing agreements, who have already relied on the presence or absence of the phrase—and the effect thereof under the Rule—in structuring their commercial transactions, as the New York Court of Appeals has recognized. *In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1086.

**6. The Questions Presented Are Ripe for Review Now.** Respondents suggest that "the petition is premature because the decision below is interlocutory." Br. in Opp. at 19. But Respondents' reference to general practices is merely an attempt to distract from the realities of this case, realities of the sort which have long led this Court to grant review in similar procedural circumstances.

As Respondents readily concede (Br. in Opp. at 6), the First Circuit properly construed the subordination language as ambiguous, as did all the courts below it: "[W]e find the subordination provisions ambiguous as to whether they provide for the priority payment of post-petition interest." Pet. App. at 21a. Since only language which is sufficiently "precise, explicit and *unambiguous*" satisfies the Rule of Explicitness, had the First Circuit applied New York's version of the Rule—as it was bound to do—the First Circuit's finding of ambiguity would have ended the inquiry and determined the outcome in favor of Petitioners. That is, of course, what the Rule of Explicitness was designed to do. Under the Rule, Petitioners would not be subjected to "differential factfinding." The Rule of Explicitness was designed to obviate the very sort of "relief" fashioned by the First Circuit in this case. Its remand to the Bankruptcy Court to conduct "differential factfinding" thus deprives Petitioners of the very certainty and predictability of the Rule on which they relied. Even were the Petitioners ultimately to prevail on remand, the damage would already be done. *See* Strickon, *supra*, at 9. ("After all, . . . a lengthy and uncertain legal battle

8. Given the First Circuit's aversion to enforcement of any state law which would explicitly give effect to the use of such a "bankruptcy" phrase, there is no reason to think Respondents' proposed "solution" would solve the problem the First Circuit has created.

over the intent of the parties to a subordination agreement regarding such interest is hardly a victory *regardless of the outcome*.") (emphasis added). Thus, it is no answer to speculate that the Bankruptcy Court may eventually determine "that the parties did not, in fact, intend for the senior creditors to recover post-petition interest." Br. in Opp. at 19. The First Circuit's refusal to apply the Rule of Explicitness is a present injury which cannot be remedied on remand and, in fact, will never be remedied if the Court denies review. Review of that refusal is thus ripe now.

Moreover, and most importantly for this Court, were the Petitioners to prevail on remand, the First Circuit's improper abrogation of the Rule as a federal interpretative canon, its improperly narrow construction of the phrase "applicable nonbankruptcy law," and its refusal to follow New York state law as expressed by its highest court, would remain undisturbed, the status of the Rule would remain conflicted between the First and Eleventh Circuits and uncertain elsewhere, and all the concomitant problems associated with that uncertainty (*see, e.g.*, Pet. at 22-24) would remain. Review now is thus not only appropriate because the questions are ripe, but because their resolution is, and will remain, important.

This Court has long recognized that it can, and should, resolve important conflicts between federal courts of appeals, or between a federal court of appeals and a state's highest court, where the reasons for granting review will not be affected by the pending remand. *See, e.g., United States v. General Motors Corp.*, 323 U.S. 373, 374, 377 (1945); *Forsyth v. City of Hammond*, 166 U.S. 506, 511-515 (1897). This is just such a case, and, accordingly, the important questions presented should be resolved now.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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